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## Special Edition

# THE ECONOMIC SITUATION

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## The Slowing National Economy and South Carolina

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### **An economic crossroad.**

Making an economic assessment when major elements of the U.S. and world economies are disturbed and still rolling may be like predicting how many balls will go to which side pocket in billiards when the initial triangle is broken. Doing so is fraught with risk and error. But events in the United States and the world in the last few days give reason to pause and reassess the economic situation.

Just since my early September report, data and actions taken in Washington and Europe point toward a rapidly deteriorating economy. I provided more than a hint of this a month ago when I was writing the September report. At the time, the effects of the sub-prime credit problem were spreading rapidly across the nation. These effects were further confounded by rapidly rising food and energy prices. Consumers were cutting back for at least two reasons: credit was tightening and family budgets were not keeping pace with the cost of what we normally think of as essential items for living: food and transportation. But things got worse in financial markets..., in a hurry.

Washington leaders moved spasmodically, energetically, and unpredictably to:

- Intervene with Bear Stearns, but not with Lehman; investment banks become banks with access to the Federal Reserve loan window,

- Nationalize the two mammoth government-created mortgage market backstops, Fannie Mae and Freddie Mac,
- Become a major lender and equity owner in one of the world's largest insurance companies, AIG,
- End suddenly short-selling of financial securities, without the due process of notice and comment rulemaking,
- But not to end until the last minute the mark-to-market accounting regulation that pushed otherwise healthy banks to the point of balance sheet insolvency.

Sincere and highly motivated actions were taken by government regulators and executives, working together in Washington, London, Brussels, and Paris, in the futile hope of giving direction to a global economy containing far more knowledge and momentum than anyone can begin to comprehend, let alone outwit. As an example, even Washington's brightest and best could not predict what happens when one major Wall Street firm is forced to reorganize and avoid bankruptcy while another is not. And none could forecast the chilling effects felt by otherwise interested private suitors who might make deals to salvage weaker firms when the highest government officials, with practically unlimited ability to write checks and force deals, enter the market in unprecedented and unpredictable ways. As indicated, the financial problem is a world problem. Banks and financial institutions across Europe are a part of a growing web of concern. And as banks fail and are reorganized, what had been a risk of inflation is replaced by a higher risk of deflation.

Uncertainty reigns supreme. As a result and perhaps for other reasons as well, interbank lending has fallen sharply below normal levels and credit markets activity has declined significantly.

Taking a U.S. perspective, what we seem to know at moment is this:

- An excess supply of newly built housing, which was produced on the basis of unsustainably low interest rate signals, expanded government-sponsored lending authority and facilitated by Wall Street investment bankers, is the source of the current financial crisis. While there is far more involved in getting us to where we are than the elements contained in the previous sentence, recovery requires that housing prices fall, or the price of everything else rises, so that the supply of housing will eventually match demand for housing. Since this problem emerged more than a year ago, housing prices on average have fallen almost 20%. It is estimated that an additional decline of 10% or more is necessary to clear the market. The financial mess we now face cannot be completely cleared until housing markets are in balance. With this in mind, it is helpful to recall that some 800,000 or more new families are formed in the U.S. each year. They are looking for homes, but household formations do not necessarily match surplus housing locations and prices.

- The Federal Reserve banking system, traditionally dedicated primarily to coordinating, regulating, and managing banks and the creation of credit, is engaged in the operation of investment banks, insurance companies, and money market funds. The central bank will soon be engaged as a managing element of purchased mortgage-back securities that emerge from the just-passed Wall Street bailout legislation. The Fed is now more closely linked to the Department of Treasury than at any time since the well-known 1941-1951 World War II “accord” when the Fed worked to keep interest rates low to fund the war. In a sense, every organization that engages in financial transactions is becoming linked to the Federal Reserve and Treasury. Because of this extension into the larger non-bank economy, the Fed’s political independence is put at risk. As indicated by frequent interaction with congress, the Fed is a handmaid to the political process, at least for now.
- The tightening of credit markets generated by the inability of some banks and other financial institutions to predict the credit worthiness of other banks and institutions is at the point where the financial economy has infected the real economy. Real estate markets are moribund in major U.S. markets. The sale of autos and other credit-sensitive products has headed to the basement. New municipal bond issues are not being offered. Commercial paper borrowing has fallen. And the rest of the economy that services major product groups—housing, autos, construction, and consumer goods—is affected.
- While all this is being sorted out, major elements of markets for land, houses, investments, commodities, and securities are in a state of disequilibrium, which generates either hardly any price movement at all due to no transactions or high volatility on a day-to-day basis.

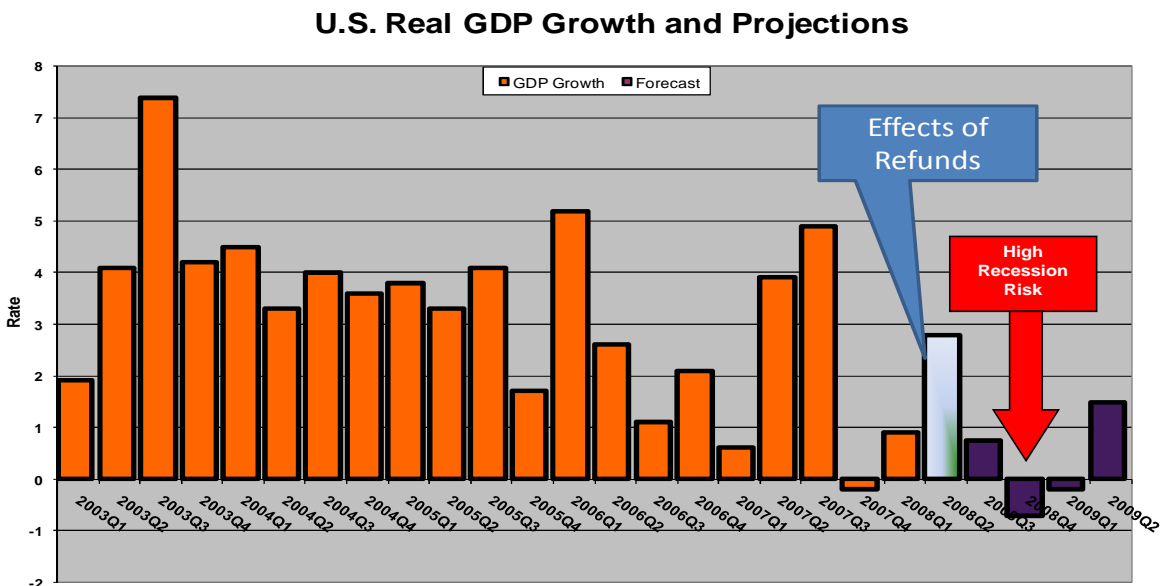
How will all this affect fundamental longer-term economic activity, once financial institutions are fully operational? There is a high hurdle to leap on the way to answering the question. Here is the hurdle: The associated sharp value decline of consumer assets—financial and real estate—and the effect on consumer net worth may have a meaningful wealth effect, which is to say that we Americans, on average, will be poorer than we were a year ago, and by enough to affect our current and future plans. Whether this behavioral response turns out to be the case, relates to assessments by people taken together as to whether or not the wealth effects alter what is thought of as estimates of permanent income. Will real estate values recover in a reasonable period of time? Will 401-K plans recover in time to meet the intentions of individual savers? These are a few of the important but unanswerable questions.

When faced with this much uncertainty, one tends to turn to data to see what the data tell us. Normally, when we think about linkages from the present to the future, the most accurate forecast is generally the simplest one, what is called a naïve forecast. A naïve forecast assumes that tomorrow will be a lot like today. But this notion of accuracy is based on an assumption of continuity in the data. But now, instead of continuity, we have to deal with discontinuity, a time of major disequilibrium in major markets.

Nonetheless, let's examine some data and see if we can determine key attributes of the current economic situation. Along the way, I will muster up some courage and offer a few forecast elements.

## The national economy.

Recently revised national GDP data show a weaker national economy, one that is growing primarily as a result of strong export sales and consumer purchases inspired by government rebates. The latest data show 2Q2008 GDP growth revised downward to 2.8% from an earlier 3.3% growth rate. A large part of this growth was driven by rebate checks designed to stimulate the economy and by strong exports. Even so, the components that brought the reduced reading include major weakness in retail sales, including a sharp reduction in auto purchases and gasoline. Data received in the last few days show a sharp drop in manufacturing activity and a run-up in the number unemployed. Domestic demand is down, and our major trading partner economies are losing steam. This, coupled with worsening credit market conditions, leads to a GDP growth picture with a recession now expected to occur during the next three quarters. The accompanying chart shows the new picture.



I expect the 2008-2009 recession to be milder in depth than the 2001 recession that generated GDP growth of 0.5% or the 1995 recession that yielded minus 0.2% growth for the year. But I expect the reduced pace of this slowdown to last longer. I expect 2008 GDP growth will be in the range of 1.1% to 1.5% and 2009 growth to range from 1.5% to 1.8%. The next table offers comparable data for most recent forecasts by the Blue Chip group, Congressional Budget Office (CBO), *The Economist* magazine, Economy.com, the International Monetary Fund (IMF), Wachovia, and the World Bank.

<b>GDP Forecasts: 2008-2009</b>
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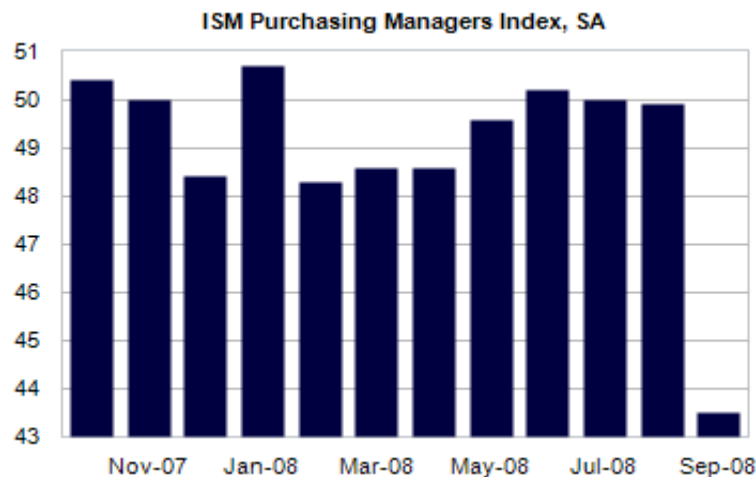
Forecast	2008	2009
Blue Chip (September)	1.8%	1.5%
CBO (September)	0.9%	1.8%
Economist.com (October)	1.6%	1.3%
Economy.com (September)	1.6%	1.0%
IMF (June)	1.3%	0.7%
Wachovia (September)	1.8%	1.8%
World Bank (September)	1.1%	1.9%
Yandle (October)	1.1% to 1.5%	1.5% to 1.8%

Some perspective is given to these numbers by noting that real GDP growth across 2000-2007 averaged 2.5%. Average growth across the stronger 1990-1999 period was 3.1%. Across 1980-1989, the average growth was 3.0%. We are obviously seeing the effects of a throttled economy that is burdened by debt and lost efficiency.

### **The quick decline in manufacturing and services.**

Data received this week show remarkable weakness. We see this in the next Economy.com chart that reports the Institute of Supply Chain Management's manufacturing index. Notice the dramatic

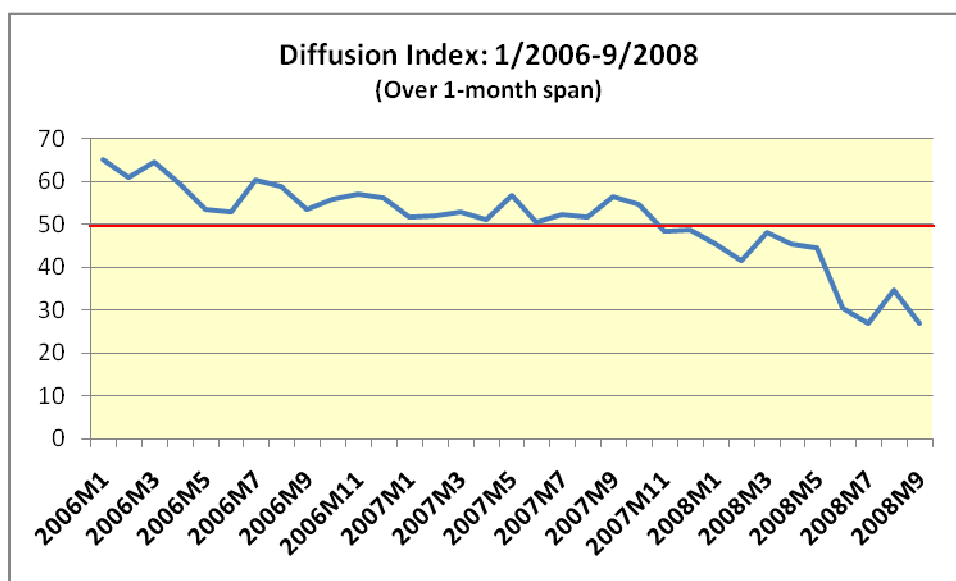
decline in September. The value fell to 43.5. Recall that a value of 50 is the zero growth point. Values less than 50 indicate a declining economy. I note that the index fell to a low of 39.2 during the 1991 recession and to 40.7 in the 2001 recession. We are close to a recession reading.



The Supply Chain Institute's data on the services economy, which arrived a few days after the manufacturing data, looked better. The September index stood at 52, having fallen from 56 in August. At least, the larger services economy was showing weak but positive growth.

The economy has a pulse.

The Bureau of Labor Statistics Manufacturing Diffusion Index for September 2008 continued to move south, as shown in the next chart. This index measures job expansion across 84 U.S. manufacturing industries. When the index has a value of 50, there are as many sectors contracting as there are expanding. When the value is less than 50, more are contracting. As indicated, the current value is 26.8. This means that in September, employment was contracting in 74% of U.S. manufacturing industries.

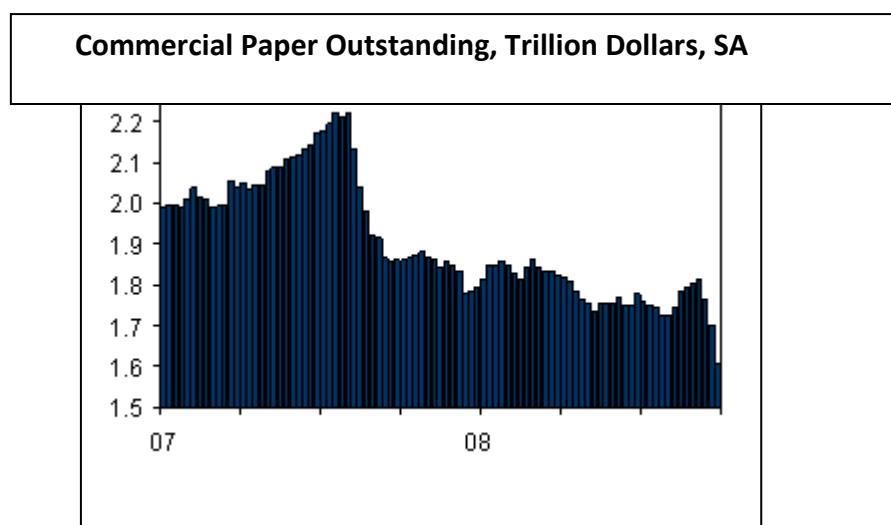


There is a broader Diffusion Index that tracks the entire nonagricultural economy and some 274 industries. That index today reads 34.1. It too is headed south. Employment in some 66% of all U.S. industries is contracting. In the 1991 recession, this broader index fell to 34.5. In the 2001 recession, the index hit 34.3.

In short, we are now reading a recession indicator.

### **The clogged financial plumbing.**

The financial economy, which normally connects real activity almost seamlessly to financial markets, is locking up in critical places. What are now called toxic assets on bank balance sheets—these are the mortgage-backed and related debt instruments—have unknown value. Investors are walking away from any form of lending to financial institutions, including the purchase of short-term commercial paper. The next chart, by Economy.com, gives the picture. I call attention to the sudden decline in September, the last observation in the chart, but also wish to point to the fact that commercial paper lending has been in a long decline since mid-2007.



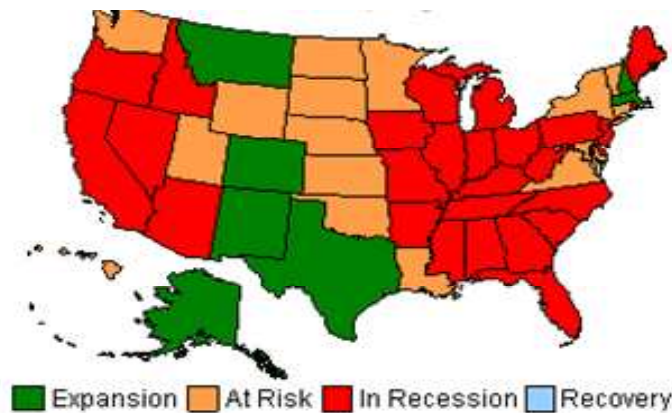
Credit market reactions to municipal bond borrowing look much like the non-action in commercial paper. In a word, there is no meaningful market for new municipal bond issues. This temporary shutdown, temporary until interbank lending resumes, is now interrupting planned construction, heavy maintenance, and rebuilding projects for states, municipalities and their agencies.

### **How the states and South Carolina are faring.**

Of course recessions do not spread their mischief evenly across the 50 states. Even in the most difficult times, there can be spots of prosperity. The next chart, produced by Economy.com, reports 27 states identified as being in recession as of August, along with states that are still avoiding the recessionary slowdown. Note that South Carolina is one of Economy.com's recession states.



### States in Recession, August 2008



Economy.com, 09.30.08

Generally speaking, the larger the concentration of manufacturing in a state, the more likely the state is currently experiencing a significant decline. Deeply embedded in this statement is the notion that heavy manufacturing concentration means older, more seasoned, manufacturing activities, and this becomes a proxy for what some term the “old economy.” In contrast, the new economy is dominated by knowledge-intensive activities, including knowledge-intensive manufacturing. The old economy uses more labor per unit of output than the new economy. When a slowdown occurs in the old economy, unemployment rates rise above the national average.

In the September employment report, the Bureau of Labor Statistics indicated that the nation’s unemployment rate remained unchanged at 6.1%, even though September payrolls had fallen by 154,000, the largest decline in more than five years and the 9<sup>th</sup> consecutive month of job losses. By comparison, the most recent state unemployment data indicate that in August, South Carolina’s unemployment rate stood at 7.6%. While the nation showed September job gains in mining, education and health services, and government, South Carolina’s August data, much like the nation, showed gains in government and education and health service. Construction,



### South Carolina High Unemployment Counties

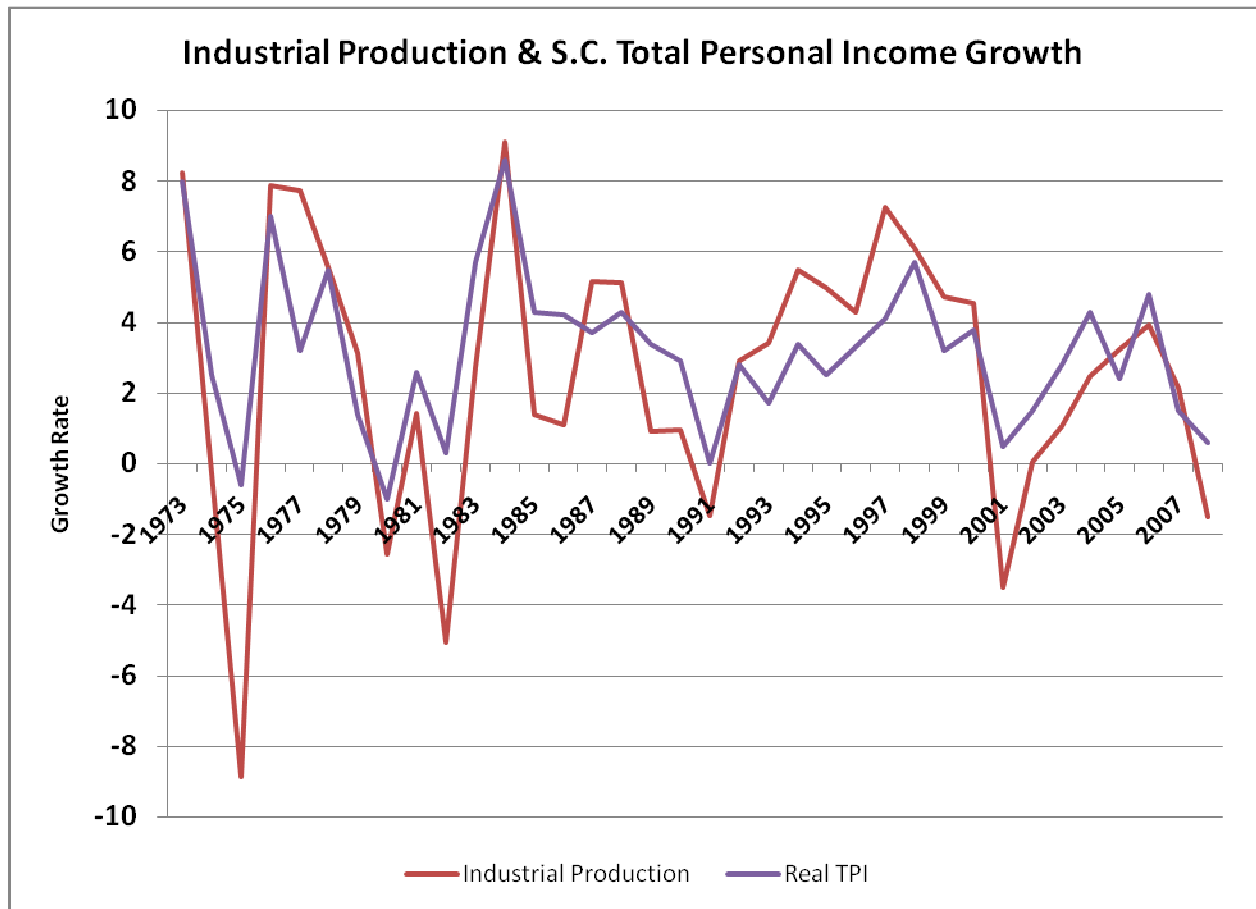
Allendale	17.2%	Lancaster	12.2%
Marion	15.2	McCormick	12.2
Bamberg	13.9	Williamsburg	11.7
Marlboro	13.3	Dillon	11.4
Chester	12.8	Clarendon	10.9
Orangeburg	12.7	Lee	10.6
Fairfield	12.6	Chesterfield	10.3
Barnwell	12.5	Hampton	10.3
Union	12.5	Colleton	10.0

Unlike the national transition from an old to a new economy that involves knowledge-intensive manufacturing and services, the transition affecting higher unemployment in South Carolina reflects primarily the transition from the production of specialized agricultural products, such as tobacco, to less intensive agricultural activity and other services. In some case, of course, a manufacturing transition is reflected in the data. Union and Orangeburg counties are examples.

I should also note the low unemployment counties. These include from lowest to highest unemployment rates Lexington, Charleston, Beaufort, Jasper, Greenville, Dorchester, Saluda, and Horry, all with less than 7% unemployment.

### Mapping S.C. Total Personal Income growth to the national economy.

South Carolina's connection to the national economy is seen clearly when growth in national industrial production data are mapped into S.C. Total Personal Income growth. The picture seen in the next chart is not very comforting. Industrial production has fallen in the most recent period, August, and by a large amount. The prospects for improvements based on what we know about manufacturing employment are not bright at all. When the data here are interpreted, one can make a projection that S.C. nominal Total Personal Income growth will average in the range of 3% to 4% in the next few quarters, if not for the next 20 months. Notice that this is nominal growth and an amount less than the rate of inflation. Current CPI inflation is approximately 4.2%. If the CPI pace continues, S.C. real income growth will be negative.



## Policy options and their prospects.

The federal government has three policy tools for addressing economic shocks that befall the country. First, there is fiscal policy. The government can reduce taxes and/or simply send checks to citizens. Of course, the state of the federal deficit imposes a constraint, but not a totally binding one. Government can print money..., and generate inflation. The fiscal policy option has been exercised. Checks were sent to a vast number of taxpayers. We see the result in 2Q2008 GDP growth. Second, government, acting through the central bank, can exercise monetary policy. The Fed can open the lending window, or even build a new window, attempt to expand the money supply, and take actions to reduce short-term interest rates. The Fed has engaged in massive monetary policy actions in an attempt to stimulate the economy and avoid the collapse of major financial institutions here and abroad. Then, there is nationalization. Government can take parts of the economy and operate them. We see this occurring in government taking ownership claims in insurer AIG, Fannie Mae and Freddie Mac.

Expanded government action in the economy brings greater uncertainty for private investors and greater risk that political incentives will overwhelm widely dispersed private incentives that guide economic life and produce wealth. Together, these forces predict a slower growing and more volatile economy. This, in my view, is where we stand in early October 2008.

## **Final thoughts.**

Even with these options being exercised, the U.S. economy still suffers from globally clogged financial plumbing. The \$700-\$800 billion bailout action taken by congress and signed by the president on October 3, 2008, will surely have an effect, but it will not bring a cure to the problem of too many houses and not enough buyers. Under an optimistic assessment, the bailout, having shifted a huge amount of uncertain mortgage debt from private lenders to U.S. taxpayers, will clear the way for more interbank lending, expanded sale of commercial paper and municipal bonds, and expanded consumer and commercial lending. At present, of course, we have no way of estimating when the transfer will occur. When it does, the short-run economic pulse beat should get stronger. At the same time, private housing markets will still be in disarray as prices fall and borrowers continue to default on their debt. Unless something is done directly to stabilize housing prices, a serious but slowly diminishing mortgage debt problem will remain.

Given the exercise of the various government options and the forces playing through the U.S. economy, I believe we are left with a recession, which is to say at least two quarters of negative economic growth. As indicated in my GDP forecast, I expect the negative growth quarters will yield slow growth for 2008, 2009, with some recovery to higher ground in late 2010. By then, housing markets should be reassembled, but the transforming of old to new economies will still be underway. I do not expect to see the U.S. economy perform at the high pace seen in the late 1990s. I expect that South Carolina will follow the national pattern but continue to underperform the U.S. economy as seen in unemployment and per capita income growth. This will mean that South Carolina per capita income will continue to fall relative to the nation in the next few years. However, S.C. population growth will exceed that of the nation, so that total personal income growth will eventually advance at a higher pace than that of the nation.

By way of summary:

- The nation's real GDP growth across 2008 and 2009 will range from 1.1% to 1.8%. Unemployment for the nation will rise to average 7.0%. During the same period, South Carolina total personal income growth will range between 3% to 4% in nominal terms, which is negative in real terms. South Carolina's unemployment rate will approach 8.5%.
- The growth pattern for the nation and South Carolina will be more saucer-shaped than V-shaped. Economic growth will be slow and extended until late 2010 when the pace of the economy will reach the lower range of more normal growth rates.

Of course, these thoughts on the economy written in early October, 2008, are based on what I know, can estimate or believe about policy actions and reactions. As always, there is more unknown than known. I will pick up on the story when I write the December Economic Situation report.